Supreme Court, U. S.
FILED
OCT 4 1977
MICHAEL RODAK, JR., CLERK

No. 76-1137

In the Supreme Court of the United States

OCTOBER TERM, 1977

ARTHUR FULMAN, ET AL., TRUSTEES, PETITIONERS

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE UNITED STATES

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OPINIONS BELOW

The memorandum and order of the district court (Pet. App. B, pp. 18-24) are reported at 407 F. Supp. 1039.[1] The opinion of the court of appeals (Pet. App. A, pp. 8-17) is reported at 545 F.2d 268.

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[1] The district court subsequently amended footnote 5 of its memorandum and order (see A. 28).

JURISDICTION

The judgment of the court of appeals was entered on November 19, 1976 (A. 4). The petition for a writ of certiorari was filed on February 17, 1977, and was granted on May 23, 1977 (A. 5). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Section 541 of the Internal Revenue Code of 1954 imposes a special tax, in addition to the corporate income tax, on a corporation that is a personal holding company and has "undistributed personal holding company income." Sections 545 and 561 allow a deduction from undistributed personal holding company income for dividends paid.

The question presented is whether a personal holding company's distribution of appreciated property to its shareholders results in a deduction for dividends paid from its undistributed personal holding company income equal to the corporation's tax basis in the distributed property, as the court of appeals held, or the fair market value of the property at the time of the distribution, as petitioners contend.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 301, 312, 316, 541, 542, 545, 547, 561 and 562 of the Internal Revenue Code of 1954, as amended (26 U.S.C.), and the Treasury Regulations on Income Tax, Section 1.562-1 (a) (26 C.F.R.), are set forth in the Appendix, *infra*, pp. 1a-15a.

STATEMENT

1. Petitioners are the successors to, and transferees of assets of, Pierce Investment Company ("Pierce"). On audit, the Commissioner of Internal Revenue determined that Pierce was a personal holding company, as defined by Section 542(a) of the Internal Revenue Code of 1954, for 1959, 1960, 1962 and 1963, and determined deficiencies in personal holding company taxes of $26,571.30 (Pet. App. A, pp. 9-10; A. 17).

Pursuant to the deficiency dividend procedure provided by Section 547 of the Code, Pierce executed a written agreement with the Commissioner in which it conceded its personal holding company status and consented to the Commissioner's determination of personal holding company taxes. Within 90 days after it executed this agreement, Pierce distributed to its shareholders shares of stock that it held in other corporations. Pierce's tax basis in these shares was $18,725.11, and at the time of distribution they had a fair market value of $32,535.[2] Thereafter, Pierce filed a claim under Section 547 of the Code for a deficiency-dividends deduction of $32,535, the fair market value of the stock it distributed to its shareholders (Pet. App. A, pp. 9-10; A. 8-13, 18).

Pursuant to Section 1.562-1(a) of the Treasury Regulations on Income Tax (26 C.F.R.), the Commissioner allowed the claimed deficiency-dividends deduction from "undistributed personal holding com-

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[2] At the time of the distribution, Pierce had accumulated earnings and profits of $42,096.76 (A. 12).

pany income" only to the extent of Pierce's adjusted basis in the distributed securities, *i.e.*, $18,725.11. He then determined deficiencies in personal holding company taxes with respect to Pierce's personal holding company income that remained undistributed. Pierce paid the tax and the Commissioner denied its claims for refund (Pet. App. A, p. 10; A. 18-19).

2. In this refund suit brought by petitioners in the United States District Court for the District of Massachusetts,[3] the district court upheld the validity of the governing Treasury Regulations that provide that a personal holding company's distribution of appreciated property to its shareholders results in a dividends-paid deduction from its undistributed personal holding company income equal to its basis in the distributed property. It accordingly ruled that Pierce could claim a deficiency-dividends deduction only to the extent of its adjusted basis in the distributed stock. The court relied upon the legislative history of Section 562 of the 1954 Code, which evidenced Congress' intention to carry forward from the 1939 Code a rule similar to that of the Regulation limiting the dividends-paid deduction in the case of a non-cash distribution to the personal holding company's adjusted basis in the distributed property (Pet. App. B, pp. 18-24).

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[3] Pierce was liquidated after this suit was initiated, and petitioners were substituted as plaintiffs (A. 25). For convenience, we use the term "petitioner" to refer to Pierce Investment Company.

The court of appeals unanimously affirmed (Pet. App. A, pp. 8-17). Like the district court, it upheld the validity of the governing Treasury Regulation as a reasonable interpretation of the personal holding company tax statute, and refused to follow the contrary decision in *H. Wetter Manufacturing Co.* v. *United States*, 458 F.2d 1033 (C.A. 6). The court of appeals observed that the legislative history of Section 562 of the 1954 Code confirmed that Congress intended to preserve the dividend valuation rule of Section 27(d) of the 1939 Code (26 U.S.C. (1952 ed.)), which had provided that the upper limit on a deduction for dividends paid in kind was the corporation's adjusted basis in the distributed property (Pet. App. A, pp. 11-12).

The court further noted that its ruling was consistent with Section 312 of the 1954 Code, which provides that a dividend that is paid in property will reduce a corporation's earnings and profits only to the extent of the corporation's adjusted basis in the property (Pet. App. A, pp. 13-14). Accordingly, the court rejected petitioner's (and the Sixth Circuit's) reliance on Section 301(b)(1) of the Code, which provides that the "amount distributed" to a non-corporate recipient of a corporate distribution is the fair market value of the property. In the court of appeals' view, that provision was not relevant in determining the amount of a personal holding company's dividends-paid deduction.

Finally, the court of appeals concluded that the adjusted-basis rule of the Regulations was in accord

with the purpose of the personal holding company tax to compel the distribution of passive investment income to the shareholders of such a corporation. As the court observed, if a personal holding company could distribute appreciated property to its shareholders and claim a dividends-paid deduction equal to the fair market value of the property, it could shield passive investment income from the personal holding company tax (Pet. App. A, pp. 15-16).

SUMMARY OF ARGUMENT

A.

Since 1934, Congress has provided for a special tax on personal holding companies in order to prevent high-bracket individuals from exploiting the lower tax rates on corporations. The tax is imposed on the "undistributed personal holding company income" of such corporations, which is generally passive investment income such as dividends, rents, and interest.

Once the Commissioner determines that a corporation is liable for the personal holding company tax, the corporation may avoid the tax by distributing its personal holding company income to its shareholders. Such distributions give rise to a "dividends-paid deduction," which reduces the undistributed personal holding company income to which the tax applies. The personal holding company tax is intended to compel the distribution of realized passive investment income to shareholders in the form of taxable dividends.

The question presented here concerns the computation of the dividends-paid deduction when a personal holding company distributes appreciated propery rather than cash to its shareholders. Petitioners claim a dividends-paid deduction equal to the fair market value of the appreciated property. However, the courts below upheld the government's position, set forth in Treasury Regulations on Income Tax, Section 1.562-1(a), that the dividends-paid deduction with respect to such non-cash distributions is limited to the distributing corporation's cost basis in the property.

The limitation on the dividends-paid deduction provided by Section 1.562-1(a) of the Regulations is both reasonable and consistent with the statutory scheme. The personal holding company tax is intended to prevent the tax avoidance that would result if realized investment income that would otherwise be taxable at progressive rates applicable to individuals could be accumulated at the corporate level. The net effect of the tax is to induce personal holding companies to distribute all of their passive investment income to the shareholders, or risk imposition of the penalty tax.

If a corporation could distribute appreciated property to its shareholders and claim a dividends-paid deduction equal to the fair market value of the property, it could retain part of its passive investment income and nevertheless avoid the personal holding company tax on such income. Section 1.562-1(a) of the Regulations therefore provides that the dividends-

paid deduction is limited to the corporation's basis in distributed property, *i.e.*, the amount of corporate earnings actually invested in the distributed property. Since the Regulation is consistent with the objectives of the personal holding company tax, the court of appeals correctly upheld its validity. See, *e.g.*, *Bingler* v. *Johnson*, 394 U.S. 741; *Commissioner* v. *South Texas Co.*, 333 U.S. 496.

Moreover, as the court of appeals correctly observed (Pet. App. A, pp. 11-14), the pertinent legislative history supports the Regulation. Section 27(d) of the Internal Revenue Code of 1939 (26 U.S.C. (1952 ed.)) provided that the upper limit on the deduction for a dividend paid in kind was the corporation's adjusted basis in the distributed property. While Congress did not include Section 27(d) in the 1954 Code, the Senate Finance Committee Report with respect to Section 562(a), which specifies the dividends to which the dividends-paid deduction applies, indicates that the rule of Section 27(d) was to be carried over into the 1954 revision. The Committee Report stated that "[t]he requirements of section[] 27(d) * * * of existing law are contained in the definition of 'dividend' in section 312, and accordingly are not restated in section 562." S. Rep. No. 1622, 83d Cong., 2d Sess. 325 (1954). While Section 312 does not explicitly address the question of the amount of the dividends-paid deduction, the Commissioner's Regulation implements the clearly-stated legislative history showing that Congress intended to

preserve the adjusted-basis rule of Section 27(d) of the 1939 Code.

Petitioners' theory that personal holding companies are entitled to a dividends-paid deduction equal to the fair market value of property distributed in kind at the time of the distribution would permit those companies to accumulate passive investment income and shelter it from the personal holding company tax by distributing appreciated property to its shareholders. As the court of appeals pointed out (Pet. App. A, pp. 16-17), acceptance of petitioners' argument would lead to disparate treatment of personal holding companies that had equal amounts of personal holding company income but invested their income in property that appreciated at different rates.

B.

Section 301(b), which requires a non-corporate distributee who receives corporate property to include such property for income tax purposes at fair market value, does not support the fair market rule for the dividends-paid deduction urged by petitioners. The language and legislative history of that provision show that it is addressed solely to the amount of a corporate distribution that the recipient shareholder is required to include in income. There is no necessary correspondence between that amount and the amount of the dividends-paid deduction to which a personal holding company is entitled. Indeed, prior to the 1954 Code, the statute contained both the basis rule for the dividends-paid deduction, now set

forth in the Treasury Regulations, and the requirement that a shareholder report as income the fair market value of property received in a corporate distribution. *H. Wetter Manufacturing Co.* v. *United States*, 458 F.2d 1033 (C.A. 6), which likewise relied upon Section 301, was therefore incorrectly decided.

Contrary to petitioners' further argument, *Ivan Allen Co.* v. *United States*, 422 U.S. 617, does not cast doubt upon the validity of the Treasury Regulation at issue in this case. There, the Court held that the net liquidation value, rather than the cost basis, of marketable securities owned by a corporation had to be taken into account in determining whether the corporation had accumulated earnings and profits beyond the reasonable needs of its business. But in so concluding, the Court emphasized that the unrealized appreciation of the securities was not included in accumulated taxable income, the base upon which the tax was imposed. However, the unrealized appreciation was relevant in appraising whether the corporation had accumulated realized earnings in excess of its reasonable business needs.

Here, on the other hand, the personal holding company tax does not contemplate the inquiry whether a corporation has accumulated earnings beyond a particular amount. The personal holding company tax base is measured entirely by realized items of income less actual disbursements. To give petitioners a dividends-paid deduction equal to the fair market value of appreciated property would distort the personal holding company tax base by introducing an

element of unrealized appreciation on the deduction side while eliminating the same element on the income side. Such an imbalance is contrary to the *Ivan Allen Co.* rationale.

ARGUMENT

A PERSONAL HOLDING COMPANY'S DISTRIBUTION OF APPRECIATED PROPERTY TO ITS SHAREHOLDERS RESULTS IN A DIVIDENDS-PAID DEDUCTION EQUAL TO ITS ADJUSTED BASIS IN THE DISTRIBUTED PROPERTY

A. Introduction

This federal income tax case presents a technical question with respect to which there is a conflict in the circuits concerning the computation of the dividends-paid deduction under the personal holding company tax imposed by Section 541 of the Internal Revenue Code of 1954.

The marginal tax rate applicable to corporations is substantially lower than that applicable to individuals.[4] In the absence of a statutory corrective, the differential between corporate and individual tax rates would permit high-bracket individual taxpayers to transfer passive investment property to a closely-held corporation, accumulate the income, and then sell or liquidate the corporation at capital gains rates,

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[4] Corporate income is subject to a 22 percent tax on the first $25,000 of taxable income and a 48 percent tax on taxable income in excess of $25,000. See Section 11 of the Internal Revenue Code of 1954. The tax rates applicable to individual income range from 14 percent to 70 percent. See Section 1 of the Code.

thereby achieving a lower net tax than if they had held the property outright.

Since 1934, the personal holding company tax has supplied the necessary corrective. It is a special tax, imposed in addition to the ordinary corporate income tax, on the income from passive investments that has been accumulated by a "personal holding company."

The tax is chiefly aimed at closely-held, investment corporations. Section 542(a) defines a "personal holding company" as a corporation, more than 50 percent of whose stock is owned, actually or constructively, by five or fewer individuals. In order to be classified as a personal holding company, at least 60 percent of the corporation's adjusted ordinary gross income for the year must constitute "personal holding company income," which Section 543(a) defines primarily as passive investment income, such as dividends, rents, and interest.[5] When it applies, the personal holding company tax is 70 percent of the corporation's undistributed personal holding company income.[6]

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[5] During 1962 and 1963, the years at issue here, a corporation became subject to the personal-holding tax only if 80 percent of its "adjusted ordinary gross income" constituted personal-holding-company income. In the Revenue Act of 1964, Section 225, 78 Stat. 79, Congress lowered the income threshold to 60 percent.

[6] During the years in issue, the tax imposed by Section 541 was 75 percent of the first $2,000 of undistributed personal holding income and 85 percent of any additional amounts. In the Revenue Act of 1964, Section 225, 78 Stat. 79, Congress reduced the tax to a flat rate of 70 percent. Neither this change nor any of the other changes made by the Revenue Act of 1964 have any relevance to the question in this case.

If a corporation meets the definition of a personal holding company and has personal holding company income, it does not automatically have to pay the personal holding company tax. From the inception of the tax, Congress has provided a "last chance" mechanism by which a corporation can avoid the personal holding company tax even after the Commissioner's determination of a deficiency. As a leading text has observed, "[b]ecause the prime purpose of the personal holding company tax is not to raise revenue but to force such corporations to distribute earnings to their shareholders (in whose hands the distributed earnings will be subject to the graduated income tax), and in recognition of the tax's virtually confiscatory rate, the Internal Revenue Code provides a locus poenitentiae in the form of the 'deficiency dividend' procedure." Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 8.20, p. 8-35 (3d ed., 1971).

Under this deficiency dividend procedure, once the Commissioner determines that a corporation is liable for the personal holding company tax, the corporation may avoid the tax by distributing its personal holding company income to its shareholders. Such distributions give rise to a "dividends paid deduction" that reduces the amount of undistributed personal holding company income to which the tax applies. See Sections 541, 545, 547, and 561 of the Code.

Thus, the personal holding company tax is an inducement to the distribution of realized passive investment income to the shareholders in the form of taxable dividends.

The question presented in this case concerns the computation of the dividends-paid deduction from undistributed personal holding company income when a personal holding company distributes property rather than cash to its shareholders. It was stipulated that Pierce was a personal holding company for the years at issue and that it was liable for approximately $26,000 in personal holding company taxes upon personal holding company income it had realized but not distributed during those years (see A. 10-11, 17-18). To avoid that liability, Pierce made a dividend distribution to its shareholders of stock that had appreciated in value in its hands (from its cost of $18,000 to its then fair market value of $32,000), and thereafter claimed a dividends-paid deduction equal to the fair market value of the stock. However, the courts below sustained the government's position, set forth in Treasury Regulations on Income Tax, Section 1.562-1(a), Appendix, *infra*, pp. 14a-15a, that the dividends-paid deduction for such non-cash distributions is limited to the corporation's basis in the property (its cost of $18,000).[7]

We submit that the decision below correctly upheld the limitation on the dividends-paid deduction provided by Section 1.562-1(a) of the Regulations as

[7] "Basis" generally constitutes the cost of the property. See Section 1012 of the Code.

both reasonable and consistent with the statutory scheme. The personal holding company tax is intended to compel personal holding companies to distribute all of their passive investment income to their shareholders. But if a corporation could distribute appreciated property and claim a dividends-paid deduction from its accumulated passive investment income equal to the fair market value of the property, it could retain part of that income and nevertheless avoid the personal holding company tax on such income.

The Regulation therefore provides that the dividends-paid deduction is limited to the corporation's basis in distributed property, *i.e.*, the amount of corporate earnings actually invested in that property. Moreover, it is consistent with the general tax treatment of corporate distributions of property other than cash. Finally, as we shall show, the Regulation is supported by the pertinent legislative history of the 1954 Code, which indicates that Congress intended to preserve an essentially similar rule under the 1939 Code.

B. The Commissioner's Regulation Limiting The Dividends-Paid Deduction To The Cost Basis Of Distributed Property Implements Congress' Intention To Compel Personal Holding Companies To Distribute Personal Holding Company Income To Their Shareholders

1. *The Statutory History*

a. Since the beginning of the modern income tax, Congress has employed various methods for preventing individuals from using corporations to shield their

personal income from the higher graduated rates applicable to individuals. Section IIA(2) of the Tariff Act of 1913, 38 Stat. 166, the first income tax statute following the adoption of the Sixteenth Amendment, imposed a tax on individual shareholders for their pro rata shares of the earnings of a corporation "formed or fraudulently availed of for the purpose of preventing the imposition of" the tax on individuals "through the medium of permitting * * * gains and profits to accumulate instead of being divided or distributed * * *." This tax continued in much the same form until 1921, when the incidence of the tax was shifted from the shareholder to the corporation. See Section 220 of the Revenue Act of 1921, 42 Stat. 247; *United States* v. *Donruss Co.*, 393 U.S. 297, 303-307.

Under the early versions of this accumulated earnings tax, the Commissioner had to prove that a corporation had accumulated earnings in order to shield its shareholders from income taxes. The difficulty of demonstrating such a purpose rendered the tax virtually ineffective as a deterrent against corporate accumulations. *Commissioner* v. *Lane-Wells Co.*, 321 U.S. 219, 221; see Preliminary Report of a Subcommittee of the House Committee on Ways and Means, *Prevention of Tax Avoidance*, 73d Cong., 2d Sess. 7 (1933). Various measures were proposed to remedy the situation.

In studying these proposals, Congress focused on one class of corporations that was notorious for its use of corporate accumulations to shield shareholders

from the graduated tax, the so-called "incorporated pocketbook." These corporations were generally formed to hold a high-income individual's investment properties or receive the income from his services and to retain the resulting earnings. The income earned from the passive investment activities was realized by the corporation, taxed at the lower corporate rates and accumulated at the corporate level to avoid tax at the higher rates applicable to the individual shareholder. See Preliminary Report, *Prevention of Tax Avoidance*, *supra*, at 6-8. See also *Commissioner* v. *Laughton*, 113 F.2d 103 (C.A. 9).

In 1934, Congress took direct action against these incorporated pocketbooks. It exempted them from the accumulated earnings tax and imposed, in addition to the corporate income tax, a special tax on the "undistributed" income of such "personal holding companies." Revenue Act of 1934, Sections 102 and 351, 48 Stat. 702-703, 751-752.[8] The new tax was designed to apply automatically to any corporation coming within its definitional provisions with respect to number of shareholders and type of income. Un-

[8] As early as 1928, proposals had been made for legislation addressed to the problem of such "personal holding companies" because of the difficulties in enforcing the accumulated earnings tax. See H.R. 1, 70th Cong., 1st Sess., Sections 104 and 105 (1927); H.R. Rep. No. 2, 70th Cong., 1st Sess. 17-18 (1927). However, at that time, the Senate Finance Committee concluded that the accumulated earnings tax adequately dealt with the problem of unreasonable accumulations (S. Rep. No. 960, 70th Cong., 1st Sess. 12 (1928)), and only those provisions were retained in the statute (H.R. Rep. No. 1882, 70th Cong., 1st Sess. 14 (1928).

der the personal holding company tax, corporations meeting the objective criteria set forth in the statute became liable for personal holding company taxes, whether or not it could be shown that the corporation had accumulated its earnings for the purpose of avoiding taxes. Thus, the personal holding company tax eliminated the problems of proof encountered by the Treasury in its enforcement of the accumulated earnings tax.[9] H.R. Rep. No. 704, 73d Cong., 2d Sess. 11-12 (1934); S. Rep. No. 558, 73d Cong., 2d Sess 13-16 (1934).

b. Since the primary purpose of the personal holding company tax is to force distributions of a personal holding company's passive investment income to its shareholders, the statutes have consistently provided that a corporation could reduce undistributed personal holding company income otherwise subject to the tax by dividends paid to shareholders.

The 1934 Act did not address the question presented in this case concerning the impact of a distribution of

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[9] In 1937 and 1964, Congress made major revisions of the personal holding company tax. These changes were intended to tighten its provisions against use of the incorporated pocketbook and to encompass other uses of the corporate form which Congress determined could be presumed to have been devised for the purpose of avoiding income tax on high-income individuals. See Report of the Joint Committee on Tax Evasion and Avoidance, *Tax Evasion and Tax Avoidance*, H.R. Doc. No. 337, 75th Cong., 1st Sess. (1937). Revenue Act of 1937, Section 1, 50 Stat. 813. See generally, Libin, *Personal Holding Companies and the Revenue Act of 1964*, 63 Mich. L. Rev. 421 (1965); Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 8.20 et seq. (3d ed., 1971).

property other than cash upon the computation of a personal holding company's "undistributed adjusted net income" that was made subject to the special tax. However, subsequent legislation soon filled the gap with respect to the effect of distributions of appreciated property upon the tax base by providing the very rule that is incorporated in the Commissioner's present Regulations.

In 1936, Congress enacted a surtax on undistributed profits (see Revenue Act of 1936, Section 14, 49 Stat. 1655), which likewise sought to discourage corporate accumulations designed to avoid the progressive individual income tax. See S. Rep. No. 2156, 74th Cong., 2d Sess. 5 (1936). The surtax on undistributed profits set forth specific rules with respect to the effect of various non-cash dividend distributions upon the tax base. Section 27(c) of the Revenue Act of 1936, 49 Stat. 1665, provided:

> If a dividend is paid in property other than money * * * the dividends paid credit with respect thereto shall be the adjusted basis of the property in the hands of the corporation at the time of the payment, or the fair market value of the property at the time of the payment, whichever is the lower.

The Revenue Act of 1936 further provided that the rule of Section 27(c) also governed the computation of the dividends-paid credit available to personal holding companies (Section 351(b)(2)(C), 49 Stat. 1732), the allowance of the dividends-paid credit available in computing the accumulated earnings tax

(Section 102(c)(2), 49 Stat. 1677), and the determination of a mutual investment company's net income subject to the normal tax (Section 13(a)(3), 49 Stat. 1655).[10]

The critical fact that emerges from this early statutory history is that the 1936 Revenue Act explicitly provided that a personal holding company's dividends-paid credit for distributions in kind could not exceed its basis in the distributed property. By contrast, that same Revenue Act further provided a completely different measure for determining the amount includable in a shareholder's income with respect to such non-cash distributions. Under Section 115(j) of the Act, 49 Stat. 1689, distributions of property were includable in the shareholder's income at the fair market value of the property at the time of the distribution.

Until the 1954 codification, each subsequent tax statute reenacted without material change both the rule of Section 27(c), limiting the corporate deduction for non-cash dividends to the adjusted basis of the distributed property, and the requirement that the shareholders include in income the fair market value

[10] While the 1936 Act and subsequent statutes referred to the adjustment for dividends paid as a "credit," the effect of the adjustment has always been the equivalent of what is now commonly characterized as a deduction, *i.e.*, the reduction of the income base upon which the tax is computed, rather than as a credit, *i.e.*, direct reduction of the tax liability itself. However, the 1954 Code characterizes the dividends paid adjustment as a "deduction." See Internal Revenue Code of 1954, Sections 561, 562, 535(a), 545(a), and 556(a).

of the distributed property.[11] Moreover, Congress extended the application of the rule of Section 27(c)[12] to the provisions dealing with the taxation of foreign personal holding companies. See Section 201 of the 1937 Act, 50 Stat. 818.

In sum, it is undisputed that from 1936 to 1954, the tax statutes uniformly provided that a non-cash dividend by a personal holding company could not reduce its undistributed personal holding company income by more than the corporation's cost basis in the distributed property. This basis limitation applied even though, under those same statutes, the recipient shareholders were required to include in their income the full fair market value of the property at the time of its distribution.

2. *The 1954 Code*

a. When Congress enacted the Internal Revenue Code of 1954, it carried forward the dividends-paid deduction for personal holding companies in Section 561, Appendix, *infra*, p. 13a. That provision states that the deduction for dividends paid "shall be the sum of—(1) the dividends paid during the taxable year, [and] (2) the consent dividends for the taxable year (determined under section 565), * * *." In turn,

[11] See Sections 27(c) and 355 of the Revenue Act of 1936, as amended by Section 1 of the Revenue Act of 1937, 50 Stat. 813; Sections 27(d), 102 and 405 of the Revenue Act of 1938, 52 Stat. 469, 483, and 560; and Sections 27(d), 102 and 504 of the Internal Revenue Code of 1939 (26 U.S.C. (1952 ed.)).

[12] Section 27(c) of the Revenue Act of 1936 was reenacted as Section 27(d) in subsequent revenue acts.

Section 545 generally defines the term "undistributed personal holding company income" as the net passive investment income of a personal holding company "minus the dividends paid deduction as defined in section 561." [13]

The text of the 1954 Code does not explicitly contain any rule comparable to the limitation of Section 27(c) of the 1936 Act (thereafter Section 27(d) of the 1939 Code), which provided that in a non-cash distribution, the dividends-paid deduction was limited to the lesser of the corporation's adjusted basis in the property or its fair market value. Nevertheless, the legislative history of the 1954 Code shows that Congress intended to preserve the adjusted-basis limitation of the prior Code. In describing the purpose of Section 562(a), the Senate Finance Committee explained (S. Rep. No. 1622, 83d Cong., 2d Sess. 325 (1954); emphasis supplied):

> Subsection (a) provides that the term "dividend" for purposes of this part shall include, except as otherwise provided in this section, only those dividends described in section 316 (relating to definition of dividends for purposes of corporate distributions). *The requirements of sections 27 (d), (e), (f), and (i) of existing law are contained in the definition of "dividend" in section 312, and accordingly are not restated in section 562.*

[13] Under the 1954 Code, the dividends-paid deduction provisions and the Regulations at issue here apply to personal holding companies (Section 545(a)), foreign personal holding companies (Section 556(a)), regulated investment companies (Section 852(b)), and to the accumulated earnings tax (Section 535(a)). In 1960, the dividends-paid deduction was also made applicable to the taxation of real estate investment trusts and their shareholders. See Section 857(b) of the Code, added by Section 10(a) of the Act of September 14, 1960, 74 Stat. 1003.

This committee report, which is virtually identical to that of the House Ways and Means Committee (H.R. Rep. No. 1337, 83d Cong., 2d Sess. A181 (1954)), demonstrates that the draftsmen of the 1954 Code intended to carry forward the adjusted basis rule of Section 27(d) of the 1939 Code. They accordingly concluded that it was unnecessary to restate the rule of Section 27(d) in Section 562 of the 1954 Code because it was already contained in the definition of dividend set forth in "section 312" of the new Code.[14]

There is nothing in Section 312 of the 1954 Code that explicitly incorporates the adjusted basis rule of Section 27(d) of the 1939 Code with respect to the dividends-paid deduction. But Section 312(a)(3) of the 1954 Code is closely analogous to Section 27(d) of the prior Code. Section 312(a)(3) provides that

[14] It is not entirely clear whether the Senate Report's reference to "section 312" intended to refer to Section 312 of the 1954 Code (dealing with earnings and profits) or to Section 312 in the House version of the 1954 Code. Section 312 of the House bill (which defined dividends) was modified by the Senate and, as modified, became Section 316 of the 1954 Code. See H.R. 8300, 83d Cong., 2d Sess. (1954). Although the court of appeals observed that a comparison of Section 312 of the 1954 Code with Section 27(d), (e), (f), and (i) suggests that the Senate Report may have had Section 312 of the *Code* in mind, it could not eliminate the inference that the reference to "section 312" as "defining" the term dividend may have been a typographical error (see Pet. App. A, p. 12 n. 2).

when a corporation distributes property to its shareholders as a dividend, its earnings and profits shall be decreased only by the adjusted basis of such property.[15] Section 27(d) of the 1939 Code similarly provided that a non-cash dividend distribution resulted in a dividends-paid deduction equal to the lesser of the adjusted basis or the fair market value of the property.

Finally, the legislative history of the 1954 Code contains further evidence that Congress intended to carry forward the rule of Section 27(d) of the 1939 Code. With respect to the taxation of regulated investment companies, the Senate Finance Committee stated that the tax treatment of regulated investment companies would be substantially the same as under Sections 361 and 362 of the 1939 Code. See S. Rep. No. 1622, *supra*, at 411. Since Section 362 of the 1939 Code expressly incorporated the adjusted basis rule of Section 27(d) of the 1939 Code, that rule is likewise applicable under the 1954 Code.

b. The foregoing legislative history of Section 562 of the 1954 Code shows that Congress intended to preserve the rule of Section 27(d) of the 1939 Code, which limited the dividends-paid deduction to an

[15] Likewise, Section 312(a)(2) provides that when a corporation distributes its own obligations as a dividend, its earnings and profits shall be reduced by the principal amount of the obligations. This rule is parallel to Section 27(e) of the 1939 Code, which provided that a corporation that distributed its obligations as a dividend, could claim a dividends-paid deduction from undistributed personal holding company income equal to the lesser of the face amount of the obligations or their fair market value.

amount equal to the adjusted basis of the distributed property. Both the House and Senate Committees responsible for reporting the 1954 codification of the tax law concluded that it was unnecessary to carry forward Section 27(d) verbatim in the new Code because "[t]he requirements of * * * [section] 27(d) * * * of existing law are incorporated in the definition of 'dividend' in section 312, and accordingly are not restated in section 562." H.R. Rep. No. 1337, *supra*, at A181; S. Rep. No. 1622, *supra*, at 325. Congress was therefore aware of the limitation of Section 27(d) and expressly approved its continued application under the 1954 Code.

The fact that the definition of "dividend" in the 1954 Code does not explicitly incorporate the dividends-paid deduction rule of Section 27(d) of the 1939 Code does not diminish the persuasive force of this legislative history. Under the settled principle of *United States* v. *Ryder*, 110 U.S. 729, 740, "[i]t will not be inferred that the legislature, in revising and consolidating the laws, intended to change their policy, unless such intention be clearly expressed." Accord: *Aberdeen & Rockfish R. Co.* v. *SCRAP*, 422 U.S. 289, 309 n. 12; *Muniz* v. *Hoffman*, 422 U.S. 454, 467-472. As the Court stated in *Fourco Glass Co.* v. *Transmirra Corp.*, 353 U.S. 222, 227, in terms that are particularly appropriate here, "no changes of law or policy are to be presumed from changes of language in the revision unless an intent to make such changes is clearly expressed."

Indeed, this case follows *a fortiori* from *Ryder*, for Congress was not silent during the 1954 revision but expressly stated its intention to preserve the dividends-paid deduction rule of Section 27(d) of the 1939 Code. Since there is nothing in the 1954 Code that abrogates the limitation of Section 27(d) and Congress undisputably intended to carry it forward, there is no basis to infer its repeal by implication. See, *e.g.*, *Regional Rail Reorganization Act Cases*, 419 U.S. 102, 133; *Mercantile National Bank* v. *Langdeau*, 371 U.S. 555, 565; *United States* v. *Borden Co.*, 308 U.S. 188, 198-199; *Amell* v. *United States*, 384 U.S. 158, 165-166.

Viewed in the context of these longstanding canons of statutory construction and the clear legislative history approving the rule of Section 27(d) of the prior law, the Commissioner's Regulation at issue in this case properly implements the intent of Congress. It is therefore hardly surprising that all of the courts that have passed upon the validity of the Regulations, including the courts that held them invalid, have agreed that the legislative history supports them. See Pet. App. A, pp. 11-12; Pet. App. B, pp. 23-24; *C. Blake McDowell, Inc.* v. *Commissioner*, 67 T.C. 1043, appeal docketed, C.A. 6, No. 77-1493; *H. Wetter Manufacturing Co.* v. *United States*, *supra*, 458 F.2d at 1035; *Gulf Inland Corp.* v. *United States*, 75-2 U.S.T.C. ¶ 9620, decided July 16, 1975 (W.D. La.), appeal pending, C.A. 5, No. 75-3767.

Like Section 27(d) of the prior Code, Section 1.562-1(a) of the Regulations limits the dividends-paid deduction to an amount equal to the adjusted basis of the distributed property. It provides:

> If a dividend is paid in property (other than money) the amount of the dividends paid deduction with respect to such property shall be the adjusted basis of the property in the hands of the distributing corporation at the time of the distribution.

The Regulation was promulgated shortly after the enactment of the 1954 Code [16] and therefore represents a contemporaneous construction of the provisions defining the dividends-paid deduction. "[T]his Court shows great deference to the interpretation given the statute by the officers or agency charged with its administration." *Udall* v. *Tallman*, 380 U.S. 1, 16. Indeed, this principle has been applied with particular frequency with respect to Treasury Regulations interpreting the Internal Revenue Code. As the Court observed in *Bingler* v. *Johnson*, 394 U.S. 741, 749-750, quoting from *Commissioner* v. *South Texas Co.*, 333 U.S. 496, 501, " it is fundamental * * * that as 'contemporaneous constructions by those charged with administration of' the Code, the Regulations 'must be sustained unless unreasonable and plainly inconsistent with the revenue statutes,' and 'should not be overruled except for weighty reasons.'" Accord: *United States* v. *Correll*, 389 U.S. 299, 306-307.

Finally, in enacting a major revision of the personal holding company tax in 1964 without altering the basis limitation rule with respect to non-cash dis-

[16] See T.D. 6308, 1958-2 Cum. Bull. 279.

tributions,[17] Congress must be deemed to have approved the Commissioner's consistent interpretation set forth in Section 1.562-1(a) of the Regulations. The Court frequently has held that "such a long-standing administrative interpretation, applying to a substantially reenacted statute, is deemed to have received congressional approval and has the effect of law." *Commissioner* v. *Noel Estate*, 380 U.S. 678, 682. Accord: *United States* v. *Correll*, *supra*, 389 U.S. at 305-306; *Helvering* v. *Winmill*, 305 U.S. 79, 83; *Fribourg Nav. Co.* v. *Commissioner*, 383 U.S. 272, 283. See also *Paragon Coal Co.* v. *Commissioner*, 380 U.S. 624, 635-636. Indeed, as we shall show, the Regulation promotes the statutory purpose of compelling personal holding company income.

c. The Regulations' adjusted basis rule is not only consonant with congressional intent, but also is in accord with the purpose of the personal holding company tax. As we indicated earlier, in the Revenue Act of 1936 Congress specifically adopted different measures for the dividends-paid credit allowable to a personal holding company for a distribution of appreciated property and the amount includable in the shareholder's income as a result of the distribution.

[17] See Revenue Act of 1964, Section 225, 78 Stat. 79. Congress also incorporated the dividends-paid deduction provisions into the provisions for taxation of real estate investment trusts enacted in 1960 (Act of September 14, 1960, Section 10(a), 74 Stat. 1003), and most recently substantially revised those provisions in the Tax Reform Act of 1976 (Pub. L. 94-455, Sections 1601-1607, 90 Stat. 1742-1757).

personal holding companies
to distribute all of their

Thus, the personal holding company tax was designed not only to prevent tax avoidance by inducing distributions that would result in taxable income to shareholders equal to the corporation's total undistributed personal holding company income. Congress went further, and permitted a personal holding company to avoid the special tax on undistributed income only to the extent that the distribution represented the company's realized earnings, *e.g.*, its basis in the distributed property.

To allow a corporation a dividends-paid deduction equal to the amount representing the income its shareholders realize from the distribution—normally the fair market value of the property distributed—would undercut the congressional design. By distributing appreciated property, a corporation could offset against its undistributed but realized income amounts that would largely represent unrealized appreciation. The corporation could thus avoid the personal holding company tax upon earnings from passive investment activities—the very type of income upon which the tax was intended to apply.

A simple example will illustrate the point. Assume that two corporations, A and B, are personal holding companies, each of which has realized and retained $1,000 of royalty income during the year. Under Section 545(a) of the Code, this $1,000 constitutes undistributed personal holding company income, which A and B must distribute to their shareholders to avoid personal holding company tax. Assume further that

A has an asset with a cost basis of $100 which is now worth $1,000, but that B has no such asset.

If A could distribute this asset and obtain a dividends-paid deduction of $1,000, it will have effectively shielded $900 of passive investment income from the personal holding company tax. On the other hand, B will be able to avoid the tax only if it distributes its entire undistributed personal holding company income of $1,000. As the court of appeals correctly observed, "[b]y basing the deduction for dividends paid on the amount of the corporation's investment in the property distributed, the regulation prevents any such income shielding" (Pet. App. A, p. 16; footnote omitted).

As the court of appeals further noted (Pet. App. A, pp. 16-17), the Regulations' adjusted basis rule is consistent with the taxable base that the 1954 Code prescribes for the personal holding company tax. In general terms, the taxable base for that tax (*i.e.*, "undistributed personal holding income") consists of the company's realized ordinary income increased by certain realized, but nontaxable income items (*e.g.*, dividends received from other corporations qualifying for the dividends-received deduction of Section 243 (see Section 545(b)(3)), and then decreased by certain actual expenses that are not recognizable for tax purposes (*e.g.*, federal income taxes and certain charitable deductions (Section 545(b)(1) and (2)). In other words, the taxable base consists of realized income, adjusted for actual expenses and distributions and certain nontaxable receipts.

The Regulation's adjusted basis rule, allowing a dividends-paid deduction for non-cash distributions only to the extent of basis, reflects this emphasis on realized income and expense items. In the normal case, a corporation's tax basis in property will equal the amount of realized, after-tax income invested in the property. Tying the deduction to basis ties it to the realized income the corporation is actually distributing.

Moreover, the Regulation is consistent with the rule Congress enacted in Section 312 of the 1954 Code. That section defines the extent to which a distribution in kind operates as a distribution "out of" a corporation's earnings and profits. Only to the extent that the distribution derives from the corporation's earnings and profits does it constitute a dividend taxable as such to the shareholders. Sections 316, 301.

A corporation does not realize taxable gain when it distributes appreciated property to its shareholders. See *General Utilities & Operating Co.* v. *Helvering*, 296 U.S. 200. See also Section 311(a) of the Code; S. Rep. No. 1622, 83d Cong., 2d Sess. 46, 247 (1954). A corporation likewise does not receive any income tax deduction for distributions of dividends.

But under the Code, a dividend distribution has an impact upon earnings and profits. A cash dividend distribution reduces the amount of earnings and profits on a dollar-for-dollar basis. See Section 312(a)(1). While the effect of a non-cash dividend distribution upon taxable earnings and profits was not

statutorily defined prior to the 1954 Code (see *Commissioner* v. *Hirshon Trust*, 213 F.2d 523 (C.A. 2), certiorari denied, 348 U.S. 861; *Commissioner* v. *Godley's Estate*, 213 F.2d 529 (C.A. 3), certiorari denied, 348 U.S. 862), Section 312(a)(3) of the 1954 Code provides that a non-cash distribution will reduce earnings and profits only to the extent of the corporation's cost basis in the distributed property. The reduction of corporate earnings and profits in the case of a dividend distribution is analogous to the deduction allowed from undistributed personal holding company income with respect to dividends paid by such corporations. The basis-limitation rule of the Commissioner's Regulation thus conforms to the treatment of earnings and profits in Section 312(a)(3).[18]

[18] In this respect, the Regulation departs from the rule of Section 27(d) of the 1939 Code, which had provided for a dividends-paid deduction for distributed property equal to its basis or fair market value, whichever was less. Under the Regulation, the deduction is always equal to the basis of the distributed property. Thus, if a corporation distributes property, the value of which has declined in its hands, it will be able to claim a deduction equal to its greater basis in the property.

Since the Regulation permits a personal holding company to distribute property whose value has declined and claim a deduction equal to its greater cost basis in such property, petitioners argue (Br. 27-29) that the Regulation is contrary to the statutory purpose of compelling distributions of all personal holding company income. As we have pointed out, there is a reference to "section 312" in the Senate Committee Report discussing Section 562 of the 1954 Code (see pp. 22-23, *supra*). The modification of the rule of Section 27(d) of the 1939 Code thus conforms the analogous dividends-paid deduction to the basis rule of Section 312(a)(3). There is accordingly support

C. Section 301(b) Does Not Support The Fair Market Rule For The Dividends-Paid Deduction Urged By Petitioners

1. Petitioners do not dispute that Section 27(d) of the 1939 Code explicitly provided that the dividends-paid deduction for non-cash distributions should equal the corporation's basis in the distributed property. They also do not challenge the fact that Sections 561 and 562 of the 1954 Code do not address the question of non-cash distributions. Section 561 merely lists the types of distributions that qualify for the deduction; Section 562 provides that to be eligible for the deduction, a distribution must fall within the defi-

in the legislative history as well as in Section 312 of the 1954 Code for the Commissioner's Regulation fixing basis as the uniform measure of the dividends-paid deduction.

General Securities Co. v. *Commissioner*, 42 B.T.A. 754, affirmed, 123 F.2d 192 (C.A. 10), upon which petitioners rely (Br. 28-29), does not support their position. There, the Board of Tax Appeals held that a personal holding company was entitled to a dividends-paid deduction under the Revenue Act of 1934 only to the extent of the fair market value of property that had declined in value while owned by the company. Although the statute at issue there (the 1934 Act) did not provide a specific measure for the deduction (see p. 18, *supra*), the Board reasoned that the deduction should be so limited because the shareholders were only taxable on the lesser value of the distributed property (see 42 B.T.A. at 758). But in enacting the Revenue Act of 1936, Congress necessarily rejected the *General Securities Co.* rationale, because that provision adopted different measures for determining the dividends-paid deduction and shareholder income (see pp. 19-20, *supra*). Accordingly, since *General Securities Co.* involved only the 1934 Act, and since the decision in that case is contrary to the dividends-paid credit statutes the Congress repeatedly has enacted since 1936, *General Securities Co.* is no longer an authoritative precedent.

nition of "dividend" set forth in Section 316. But Section 316 specifies only the source of payment out of which a corporation must make a distribution in order to meet the definition of a dividend. Petitioners therefore acknowledge (Br. 18) that it "provides no rule of valuation."

However, petitioners argue (Br. 13-18) that Section 316 must be read together with Section 301(b). The latter provision states that the amount of a corporate distribution that a non-corporate recipient must include in income is "the amount of money received, plus the fair market value of the other property received." In petitioners' view, the combined reading of Sections 301, 316, and 562 establishes that the Code requires that the amount of the dividends-paid deduction be equal to the amount that the recipient shareholder must include in his income.

We agree that Sections 301 and 316 must be read together to determine the tax consequences of a distribution at the shareholder level. See 1 Mertens, *Law of Federal Income Taxation* § 9.55 (1974 rev.). But it does not follow that these two provisions must be read together to determine the dividends-paid deduction at the corporate level. To the contrary, petitioners have not shown that Congress intended that the amount of a distribution for shareholder tax purposes, governed by Section 301(b), should also govern the dividends-paid deduction permitted to the corporation. As Judge Tannenwald observed for a majority of the Tax Court in *C. Blake McDowell, Inc.* v. *Commissioner, supra*, 67 T.C. at 1051,[19] in rejecting a similar contention:

> We are unimpressed by the argument, essentially grounded on policy considerations, that so long as the distributee is taxed on the full value of the distribution, the distributing corporation should be allowed a deduction for the same amount. The argument was available prior to 1954 and yet for more than a decade Congress saw fit to measure the deduction in terms of the distributing corporation's investment rather than the distributee's taxable receipt. Indeed, there is a discernible rationale that this was done to effectuate a countervailing policy of taxing or forcing distribution of *income* rather than unrealized appreciation. [Emphasis in original.]

Moreover, nothing in the language of Sections 301 (b), 316, or 562 suggests that the former provision should come into play in determining the amount of the corporate dividends-paid deduction. Indeed, the legislative history of Section 301 states unambiguously that it was intended to prescribe the tax consequences of distributions *at the shareholder level*. S. Rep. No. 1622, *supra*, at 231; H.R. Rep. No. 1337, *supra*, at A70. There is accordingly no basis to petitioners' argument that Section 301(b) prescribes a

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[19] Despite its view that the Regulation was valid, the Tax Court in *C. Blake McDowell, Inc.* held for the taxpayer because of its *Golsen* rule that it follows the decision of the circuit (*H. Wetter Manufacturing Co.* v. *United States, supra*) to which the case would be appealed. See *Golsen* v. *Commissioner*, 54 T.C. 742, affirmed on the substantive issue, 445 F.2d 985 (C.A. 10), certiorari denied, 404 U.S. 940.

fair market value measure of the dividends-paid deduction for non-cash distributions.

Finally, as the court of appeals properly observed (Pet. App. A, p. 15), Section 301(b) is not practically suited to the role petitioners seek for it. If Section 301(b) were to determine the amount of the dividends-paid deduction for a non-cash distribution in kind, the amount of a personal holding company's deduction would vary according to whether its shareholders were corporations or individuals. Under Section 301(b)(1)(A), distributions to non-corporate distributees are measured by the fair market value of the property distributed. Section 301(b)(1)(B), on the other hand, requires corporate distributees to report only the lesser of the fair market value or the distributor corporation's adjusted basis in the distributed property as the "amount" distributed.

While petitioners assert (Br. 11-12) that there is nothing anomalous in varying the dividends-paid deduction in accordance with the character of the recipient, they suggest no reason why the amount of the deduction should turn on such considerations. Indeed, the distinct income inclusion rules of Section 301 would require that a personal holding company with both corporate and non-corporate shareholders trace the distribution to its ultimate recipients in order to compute its dividends-paid deduction. In the absence of any legislative history supporting the proposition that Congress intended in 1954 to substitute such a complex system of measuring dividends paid for the uniform rule that had previously been in force for

almost 20 years, the court of appeals correctly rejected petitioners' reliance upon Section 301(b).[20]

H. Wetter Manufacturing Co. v. *United States*, *supra*, upon which petitioners rely (Br. 13, 22), was therefore incorrectly decided. There, the Sixth Circuit held that Sections 301, 316 and 562 unambiguously required that the dividends-paid deduction for non-cash distributions be equal to the fair market value of the distributed property. Although the court conceded that the legislative history of Section 562 supported the Commissioner's Regulation, it concluded that the "plain meaning" of Sections 301, 316 and 562 foreclosed reference to the legislative history (see 458 F.2d at 1034-1035).

But as we have pointed out *supra*, pp. 21-22, none of these provisions addresses the proper measure of the dividends-paid deductions. There is accordingly no basis for the Sixth Circuit's derogation of the clearly-stated legislative history in the face of the "plain meaning" of the statute, because the statute is completely silent on the question. Since the Commissioner's Regulation implements the intent of Congress by "filling the statutory gaps" and is in all re-

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[20] As the court of appeals observed (Pet. App. A, pp. 16-17), petitioners' rule leads to a further anomaly. Under that rule, two personal holding companies with identical amounts of undistributed income subject to the personal holding company tax and identical amounts invested in different corporate assets might be subject to different taxes after distributing those assets as dividends, because the assets had appreciated at different rates while in the companies' hands. The different taxes would be unrelated to the companies' disposition of the earnings subject to the tax.

spects consistent with the overall policy of the personal holding company tax to compel distributions, the decision below properly rejected the *H. Wetter Manufacturing Co.* rationale.

2. Petitioners' further reliance (Br. 18-21) upon *Ivan Allen Co.* v. *United States*, 422 U.S. 617, is likewise misplaced. There, the Court held that certain listed and readily marketable securities owned by the taxpayer corporation had to be taken into account at their net liquidation value for the purpose of determining whether it had permitted its earnings and profits to accumulate beyond the reasonable needs of its business within the meaning of Section 533(a) of the Code. Petitioners argue that because the Court in *Ivan Allen* ruled that the true economic value of corporate assets was a critical factor in the determination of the applicability of the accumulated earnings tax, the same measure should be used here in computing Pierce's liability for personal holding company taxes.

But petitioners' reading of *Ivan Allen* misses the point of that decision. As the Court there noted (422 U.S. at 627-628):

> It is important to emphasize that we are concerned here with a tax on "accumulated taxable income," § 531, and that the tax attaches only when a corporation has permitted "earnings and profits to accumulate instead of being divided or distributed," § 532(a). What is essential is that there be "income" and "earnings and profits." This at once eliminates, from the measure of the tax itself, any unrealized appreciation in the

> value of the taxpayer's portfolio securities over cost, for any such unrealized appreciation does not enter into the computation of the corporation's "income" and "earnings and profits."
>
> The corporation's readily marketable portfolio securities and their unrealized appreciation, nonetheless, are of profound importance in making the entirely discrete determination whether the corporation has permitted what, concededly, are earnings and profits to accumulate beyond its reasonable business needs. If the securities, as here, are readily available as liquid assets, then the recognized earnings and profits that have been accumulated may well have been unnecessarily accumulated, so far as the reasonable needs of the business are concerned. * * * In any event—and we repeat—the tax is directed at the accumulated taxable income and at earnings and profits. The tax itself is not directed at the unrealized appreciation of the liquid assets in the securities portfolio.

Thus, while the Court concluded that the net liquidation value of the securities must be considered in determining whether the taxpayer had unreasonably accumulated earnings, it emphasized that the unrealized appreciation in the securities was not includable in accumulated taxable income, the accumulated earnings tax base (see 422 U.S. at 627-628, 633, 634).

Here, on the other hand, there is no similar inquiry under the personal holding company tax that would take unrealized appreciation into account in determining whether a corporation is liable for the special tax. The personal holding company tax base is comprised entirely of realized items of income less actual dis-

bursements. See Section 545 of the Code. Thus, petitioners' fair market rule would distort the personal holding company tax base by permitting unrealized appreciation to serve as a deduction and thereby reduce the tax while not taking it into account on the income side. The Commissioner's Regulation is entirely consistent with the *Ivan Allen* rationale of excluding unrealized appreciation from the tax base.[21]

3. Finally, the fair market rule urged by petitioners is also contrary to other taxes that Congress has made subject to the dividends-paid deduction. In the tax treatment applicable to real estate investment trusts and regulated investment companies, Congress sought to permit groups of small investors to pool their funds and to obtain the investment advantages generally available to large investors, with only a minimum tax cost at the corporate level. But as a prerequisite to qualifying for these substantial tax benefits, Congress required the trusts and investment companies to distribute a high percentage of their ordinary income from investment activities as dividends to their investors each year. See Sections 852 and 857

[21] There are additional difficulties with petitioners' reliance on *Ivan Allen*. Thus, petitioners emphasize (Br. 20-21) that the dividends-paid deduction must equal fair market value so as to accord with the "economic reality" of a corporation's dividend in kind of appreciated property. But they do not explain how that assertion can be reconciled with their further assertion that Section 301(b) is to control the amount of a dividends-paid deduction, which would limit the deduction in situations involving corporate distributees to the lesser of adjusted basis or fair market value.

of the Code.[22] The dividends paid deduction provisions of Section 561, *et seq.* of the Code, including the Treasury Regulations directly in issue here, govern the determination whether this minimum distribution requirement has been met.

If these real estate investment trusts and regulated investment companies could measure the dividends-paid deduction for non-cash distributions by the fair market value of the property, it would be possible for them to satisfy the minimum distribution requirements by distributing appreciated assets representing actual earnings only to the extent of adjusted basis. The result would be that these entities would avoid tax treatment as corporations even though they would be retaining earnings just as any ordinary corporation. The rule we urge here, set forth in the Commissioner's Regulation, prevents this circumvention of the congressional design by allowing non-cash dividends to satisfy the minimum distribution requirement only to the extent of the basis of the distributed property. See Rev. Rul. 57-421, 1957-2 Cum. Bull. 367.

[22] See generally Sections 851-855 of the Code for provisions relating to regulated investment companies, and Sections 856-860 of the Code, as amended by the Tax Reform Act of 1976, Pub. L. 94-455, Sections 1601-1607, 90 Stat. 1742-1757, for the provisions concerning real estate investment trusts. See also H.R. Rep. No. 2020, 86th Cong., 2d Sess. (1960), and H.R. Rep. No. 2214, 86th Cong., 2d Sess. 8 (1960).

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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OCTOBER 1977.

* The Solicitor General is disqualified in this case.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C. (1958 ed. and Supp. V)):

SEC. 301. DISTRIBUTION OF PROPERTY.

(a) *In General.*—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

(b) *Amount Distributed.*—

(1) *General Rule.*—For purposes of this section, the amount of any distribution shall be—

(A) *Noncorporate Distributees.*—If the shareholder is not a corporation, the amount of money received, plus the fair market value of the other property received.

(B) [as amended by Sec. 13(f)(2), Revenue Act of 1962, 76 Stat. 1035] *Corporate Distributees.*—If the shareholder is a corporation, the amount of money received, plus whichever of the following is the lesser:

(i) the fair market value of the other property received; or

(ii) the adjusted basis (in the hands of the distributing corporation immediately before the dis-

tribution) of the other property received, increased in the amount of gain to the distributing corporation which is recognized under subsection (b) or (c) of section 311 or under section 1245(a).

* * * * *

(c) *Amount Taxable.*—In the case of a distribution to which subsection (a) applies—

(1) *Amount constituting dividend.*—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

* * * * *

(d) *Basis.*—The basis of property received in a distribution to which subsection (a) applies shall be—

(1) *Noncorporate distributees.*—If the shareholder is not a corporation, the fair market value of such property.

(2) [as amended by Sec. 13(f)(2), Revenue Act of 1962, 76 Stat. 1035] *Corporate distributees.*—If the shareholder is a corporation, whichever of the following is the lesser:

(A) the fair market value of such property; or

(B) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of such property, increased in the amount of gain to the distributing corporation which is recognized under subsection

(b) or (c) of section 311 or under section 1245(a).

* * * * *

SEC. 312. EFFECT ON EARNINGS AND PROFITS.

(a) *General Rule.*—Except as otherwise provided in this section, on the distribution of property by a corporation with respect to its stock, the earnings and profits of the corporation (to the extent thereof) shall be decreased by the sum of—

(1) the amount of money,

(2) the principal amount of the obligations of such corporation, and

(3) the adjusted basis of the other property, so distributed.

* * * * *

SEC. 316. DIVIDEND DEFINED.

(a) *General Rule.*—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

(b) *Special Rules.*—

* * * * *

(2) *Distributions by personal holding companies.*—In the case of a corporation which—

(A) under the law applicable to the taxable year in which the distribution is made, is a personal holding company (as defined in section 542), or

(B) for the taxable year in respect of which the distribution is made under section 563(b) (relating to dividends paid after the close of the taxable year), or section 547 (relating to deficiency dividends), or the corresponding provisions of prior law, is a personal holding company under the law applicable to such taxable year,

the term "dividend" also means any distribution of property (whether or not a dividend as defined in subsection (a)) made by the corporation to its shareholders, to the extent of its undistributed personal holding company income (determined under section 545 without regard to distributions under this paragraph) for such year.

* * * * *

SEC. 541. IMPOSITION OF PERSONAL HOLDING COMPANY TAX.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the undistributed personal holding company income (as defined in section 545) of every personal holding company (as defined in section 542) a personal holding company tax equal to the sum of—

(1) 75 percent of the undistributed personal holding company income not in excess of $2,000, plus

(2) 85 percent of the undistributed personal holding company income in excess of $2,000.

SEC. 542. DEFINITION OF PERSONAL HOLDING COMPANY.

(a) *General Rule.*—For purposes of this subtitle, the term "personal holding company" means any corporation (other than a corporation described in subsection (c)) if—

(1) *Gross income requirement.*—At least 80 percent of its gross income for the taxable year is personal holding company income as defined in section 543, and

(2) *Stock ownership requirement.*—At any time during the last half of the tax-

able year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals. * * *

* * * * *

SEC. 545. UNDISTRIBUTED PERSONAL HOLDING COMPANY INCOME.

(a) *Definition.*—For purposes of this part, the term "undistributed personal holding company income" means the taxable income of a personal holding company adjusted in the manner provided in subsection (b), minus the dividends paid deduction as defined in section 561.

(b) *Adjustments to Taxable Income.*—For the purposes of subsection (a), the taxable income shall be adjusted as follows:

(1) [as amended by Sec. 9(d)(2), Revenue Act of 1962, 76 Stat. 1001] *Taxes.*—There shall be allowed as a deduction Federal income and excess profits taxes (other than the excess profits tax imposed by subchapter E of chapter 2 of the Internal Revenue Code of 1939 for taxable years beginning after December 31, 1940) and income, war profits and excess profits taxes of foreign countries and possessions of the United States (to the extent not allowable as a deduction under section 164(b)(6)), accrued during the taxable year or deemed to be paid by a domestic corporation under section 902(a)(1) or 960(a)(1)(C) for the taxable year, but not including the accumulated earnings tax imposed by section 531,

the personal holding company tax imposed by section 541, or the taxes imposed by corresponding sections of a prior income tax law. A taxpayer which, for each taxable year in which it was subject to the tax imposed by section 500 of the Internal Revenue Code of 1939, deducted Federal income and excess profits taxes when paid for the purpose of computing subchapter A net income under such Code, shall deduct taxes under this paragraph when paid, unless the taxpayer elects, in its return for a taxable year ending after June 30, 1954, to deduct the taxes described in this paragraph when accrued. Such an election shall be irrevocable and shall apply to the taxable year for which the election is made and to all subsequent years.

(2) [as amended by Sec. 32(a), Technical Amendments Act of 1958, 72 Stat. 1631] *Charitable contributions.*—The deduction for charitable contributions provided under section 170 shall be allowed, but in computing such deduction the limitations in section 170(b)(1)(A) and (B) shall apply, and section 170(b)(2) shall not apply. For purposes of this paragraph, the term "adjusted gross income" when used in section 170(b)(1) means the taxable income computed with the adjustments (other than the 5-percent limitation) provided in the first sentence of section 170(b)(2) and under paragraph (8) of this subsection.

(3) *Special deductions disallowed.*—The special deductions for corporations provided

in part VIII (except section 248) of subchapter B (section 241 and following, relating to the deduction for dividends received by corporations, etc.) shall not be allowed.

(4) [as amended by Sec. 32(b), Technical Amendments Act of 1958, 72 Stat. 1631] *Net operating loss.*—The net operating loss deduction provided in section 172 shall not be allowed, but there shall be allowed as a deduction the amount of the net operating loss (as defined in section 172(c)) for the preceding taxable year computed without the deductions provided in part VIII (except section 248) of subchapter B.

(5) *Long-term capital gains.*—There shall be allowed as a deduction the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year, minus the taxes imposed by this subtitle attributable to such excess. The taxes attributable to such excess shall be an amount equal to the difference between—

(A) the taxes imposed by this subtitle (except the tax imposed by this part) for such year, and

(B) such taxes computed for such year without including such excess in taxable income.

(6) *Bank affiliates.*—There shall be allowed the deduction described in section 601 (relating to bank affiliates).

(7) *Payment of indebtedness incurred prior to January 1, 1934.*—There shall be allowed as a deduction amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred before January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness.

(8) *Expenses and depreciation applicable to property of the taxpayer.*—The aggregate of the deductions allowed under section 162 (relating to trade or business expenses) and section 167 (relating to depreciation), which are allocable to the operation and maintenance of property owned or operated by the corporation, shall be allowed only in an amount equal to the rent or other compensation received for the use of, or the right to use, the property, unless it is established (under regulations prescribed by the Secretary or his delegate) to the satisfication of the Secretary or his delegate—

(A) that the rent or other compensation received was the highest obtainable, or, if none was received, that none was obtainable;

(B) that the property was held in the course of a business carried on bona fide for profit; and

(C) either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

(9) *Amount of a lien in favor of the United States.*—There shall be allowed as a deduction the amount, not to exceed the taxable income of the taxpayer, of any lien in favor of the United States (notice of which has been filed as provided in section 6323(a)(1), (2), or (3)) to which the taxpayer is subject at the close of the taxable year. The sum of the amounts deducted under this paragraph with respect to any lien shall, for the purposes of this section, be added to the taxable income of the taxpayer for the taxable year in which such lien is satisfied or released. Where an amount is added to the taxable income of a corporation by reason of the preceding sentence of this paragraph, the shareholders of the corporation may, pursuant to regulations prescribed by the Secretary or his delegate, elect to compute the income tax with respect to such dividends as are attributable to such amount as though they were received ratably over the period the lien was in effect.

(10) [as added by Sec. 3(d), Act of February 2, 1962, 76 Stat. 7] *Distributions of divested stock.*—There shall be allowed as a deduction the amount of any income attributable to the receipt of a distribution of divested stock (as defined in subsection (e) of section 1111), minus the taxes imposed by this subtitle attributable to such receipt, but only if the stock with respect to which the distribution is made was owned by the distributee on September 6, 1961, or

was owned by the distributee for at least 2 years prior to the date on which the antitrust order (as defined in subsection (d) of section 1111) was entered.

(11) [as added by Sec. 3(d), Act of February 2, 1962, 76 Stat. 7] *Special adjustment on disposition of antitrust stock received as a dividend.*—If—

(A) a corporation received antitrust stock (as defined in section 301(f)) in a distribution to which section 301 applied,

(B) the amount of the distribution determined under section 301(f)(2) exceeded the basis of the stock determined under section 301(f)(3), and

(C) Paragraph (10) did not apply in respect of such distribution,

then proper adjustment shall be made, under regulations prescribed by the Secretary or his delegate, if such stock (or other property the basis of which is determined by reference to the basis of such stock) is sold or exchanged.

SEC. 547. DEDUCTION FOR DEFICIENCY DIVIDENDS.

(a) *General Rule.*—If a determination (as defined in subsection (c)) with respect to a taxpayer establishes liability for personal holding company tax imposed by section 541 (or by a corresponding provision of a prior income tax law) for any taxable year, a deduction shall be allowed to the taxpayer for the amount of de-

ficiency dividends (as defined in subsection (d)) for the purpose of determining the personal holding company tax for such year, but not for the purpose of determining interest, additional amounts, or assessable penalties computed with respect to such personal holding company tax.

* * * * *

(c) *Determination.*—For purposes of this section, the term "determination" means—

(1) a decision by the Tax Court or a judgment, decree, or other order by any court of competent jurisdiction, which has become final;

(2) a closing agreement made under section 7121; or

(3) under regulations prescribed by the Secretary or his delegate, an agreement signed by the Secretary or his delegate and by, or on behalf of, the taxpayer relating to the liability of such taxpayer for personal holding company tax.

(d) *Deficiency Dividends.*—

(1) *Definition.*—For purposes of this section, the term "deficiency dividends" means the amount of the dividends paid by the corporation on or after the date of the determination and before filing claim under subsection (e), which would have been includible in the computation of the deduction for dividends paid under section 561 for the taxable year with respect to which the liability for personal holding company tax exists, if distributed during such taxable year. No dividends shall be considered as deficiency dividends for purposes of subsection (a) unless distributed within 90 days after the determination.

* * * * *

SEC. 561. DEFINITION OF DEDUCTION FOR DIVIDENDS PAID.

(a) *General Rule.*—The deduction for dividends paid shall be the sum of—

(1) the dividends paid during the taxable year,

(2) the consent dividends for the taxable year (determined under section 565), and

(3) in the case of a personal holding company, the dividend carryover described in section 564.

(b) [as amended by Sec. 3(f), Act of February 2, 1962, 76 Stat. 8] *Special Rules Applicable.*—

(1) In determining the deduction for dividends paid, the rules provided in section 562 (relating to rules applicable in determining dividends eligible for dividends paid deduction) and section 563 (relating to dividends paid after the close of the taxable year) shall be applicable.

* * * * *

SEC. 562. RULES APPLICABLE IN DETERMINING DIVIDENDS ELIGIBLE FOR DIVIDENDS PAID DEDUCTION.

(a) *General Rule.*—For purposes of this part, the term "dividend" shall, except as otherwise provided in this section, include only dividends described in section 316 (relating to definition of dividends for purposes of corporate distributions).

* * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.562-1 *Dividends for which the dividends paid deductions is allowable*

(a) *General rule.* Except as otherwise provided in section 562(b) and (d), the term "dividend", for purposes of determining dividends eligible for the dividends paid deduction, refers only to a dividend described in section 316 (relating to definition of dividends for purposes of corporate distributions). No distribution, however, which is preferential within the meaning of section 562(c) and § 1.562-2 shall be eligible for the dividends paid deduction. Moreover, when computing the dividends paid deduction with respect to a United States person (as defined in section 957(d)), no distribution which is excluded from the gross income of a foreign corporation under section 959(b) with respect to such person or from the gross income of such person under section 959(a) shall be eligible for such deduction. Further, for purposes of the

dividends paid deduction, the term "dividend" does not include a distribution in liquidation unless the distribution is treated as a dividend under section 316(b)(2) and paragraph (b)(2) of § 1.316-1, or under section 333(e)(1) and paragraph (c) of § 1.333-4 or paragraph (c)(2), (d)(1)(ii), or (d)(2) of § 1.333-5, or qualifies under section 562(b) and paragraph (b) of this section. If a dividend is paid in property (other than money) the amount of the dividends paid deduction with respect to such property shall be the adjusted basis of the property in the hands of the distributing corporation at the time of the distribution. See paragraph (b)(2) of this section for special rules with respect to liquidating distributions by personal holding companies occurring during a taxable year of the distributing corporation beginning after December 31, 1963. Also see section 563 for special rules with respect to dividends paid after the close of the taxable year.

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